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European Federation of Leasing Company Associations

Kerstin af Jochnick  
Chair  
Committee of European Banking Supervisors  
(CEBS)

By email: cp16@c-eps.org

Brussels, 22 February, 2008

**Leaseurope's Response to the Second consultation paper on CEBS'  
technical advice to the European Commission on the review of the Large  
Exposures rules**

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Dear Mrs af Jochnick,

Please find Leaseurope's response to CEBS's second consultation on large exposures attached.

Our response focuses on the elements of the consultation that are directly related to business of European leasing firms. These can be briefly summarised under the following two categories:

**1. Credit risk mitigation**

With ownership of the leased asset being a central feature of leasing contracts, our main issues in the context of large exposures relate to the recognition of physical collateral under a new regime. Consequently, we welcome CEBS's current thinking which is to recognise real estate collateral in a simple manner in the new framework. However, we do not agree with the approach CEBS has adopted in its CP regarding non real estate collateral. While we fully understand that CEBS has concerns as to the liquidity of other physical collateral, we are of the opinion that leased assets can be realised in a timely manner and with relative certainty as to the recoverable amount. We have therefore developed our arguments supporting this statement within the attached paper, as requested by Jesús Ibáñez, chair of the Working Group on Large Exposures during the public hearing on 15 January.

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## **2. Intra-group exposures, scope of application and interbank exposures**

Leaseurope is concerned that CEBS's current proposal regarding intra-group exposures would result in restricted funding availability for certain European leasing firms. Additionally, due to the varying levels of application of the rules for leasing firms, there is a clear level playing field issue for the European leasing industry. Finally, we foresee that constraints will be placed on institutions' liquidity management, particularly when they are smaller institutions, as is often the case for leasing firms.

For any further information you may require on the above points or for queries on our detailed response, please do not hesitate to contact me or Jacqueline Mills at [j.mills@leaseurope.org](mailto:j.mills@leaseurope.org) or +32 2 778 05 66.

Yours sincerely,

Tanguy van de Werve  
LEASEUROPE DIRECTOR GENERAL

### **Copy to:**

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### **About Leaseurope**

**Leaseurope**, the European Federation of Leasing Company Associations, is composed of 47 Member Associations in 34 countries. It represents as an umbrella body the European leasing and automotive rental industries. In 2006, its leasing members accounted for 92% of the European leasing market. In April 2006, the Federation integrated short and long term car and truck renters into its membership base. It now represents around 8 500 companies across Europe employing over 200 000 people. During the course of 2006, the companies represented via Leaseurope financed 297,5 billion euros of new investments in vehicles, equipment and real estate.



## **Leaseurope's Response to the Second consultation paper on CEBS' technical advice to the European Commission on the review of the Large Exposures rules**

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1. Leaseurope has focused its response to CEBS's second consultation paper on large exposures on areas that are of particular significance for the European leasing industry and where the Federation can best provide input based on its sphere of expertise. This does not mean to say that other general concepts of the new regime such the notion of connected clients or exposure value definitions are not of importance for the leasing industry but rather that they are perhaps best dealt with by other representative bodies of a more general nature. Leaseurope has therefore provided responses to a limited number of issues and questions raised in CEBS's consultation paper (CP). The questions to which we have chosen to respond are highlighted below and address the following issues: credit risk mitigation, intra-group exposures, scope of application of the new regime and interbank exposures.

### **I. Credit Risk Mitigation**

Q9. Do you agree that for large exposures purposes there can be cases where it is justified to treat mitigation techniques in a different way from the treatment under the minimum capital requirements framework? Please explain your view and provide examples. And where relevant, please provide feed back on the costs and benefits.

2. Leaseurope considers that CEBS's approach of trying to maintain the recognition of mitigation effects as close to the equivalent treatment for minimum capital requirements purposes is in line with the general philosophy it has adopted in setting out its thinking in its second consultation paper on large exposures. Nevertheless, as CEBS explains, there will be cases where it is not possible to fully align mitigation treatment under both the minimum capital requirement framework and a new large exposure regime. Although, as CEBS states, this will lead to institutions having to run three sets of calculations in parallel for credit risk mitigation (for internal, capital requirement and large exposure purposes), it will in some cases be unavoidable as the way mitigation is recognised for minimum capital purposes cannot always be directly transposed into a large exposure regime. For example, in some cases, mitigation is reflected in a modified risk weight or LGD and may depend on the approach taken for minimum capital calculations. When there is no choice but to devise a separate approach under the large exposure framework, differing recognition of mitigation in the large exposure regime should therefore be as simple and as straightforward as possible to avoid additionally unnecessary costs in terms of institutions' requirements.

3. However, while the actual taking into account of the effect of the funded or unfunded protection may vary between the various regimes, Leaseurope sees no justification to differentiate between the types of protection that may be eligible under the regimes, particularly if they are subject to the same sets of requirements. We agree that relative certainty regarding the recoverable amount and timely realisation of protection is key under a large exposure regime, yet we believe that the conditions of Annex VIII of the CRD relating to the eligibility and minimum requirements for the recognition of protection are more than sufficient to ensure that the protection is effective in its role if its execution is required.
  
4. In the case of leased assets in particular, where the leased good serves as collateral to the lease exposure and remains the property of the lessor during the entire lease contract, realisation will be timely as there is no need to execute a mortgage or other type of lien and, particularly in the case of leases of standardised assets, which constitute the vast majority of lease contracts made by our members, the recoverable amount will be relatively certain. We are therefore of the opinion that a vast number of leased assets will meet CEBS's liquidity criteria and have developed this argumentation further in paragraphs 8 to 15 of our response.

#### Alternatives for Dealing with CRM under a Large Exposure Regime

Q10. Do you agree that the three alternatives set out for the recognition of CRM techniques are the relevant ones? Do you think there are other alternatives CEBS should consider? Please explain your views and provide examples. And where relevant, please provide feed back on the costs and benefits

Q11. Are there costs/benefits that have not been identified? Are the costs/benefits identified correctly assessed? In particular could you provide CEBS with more information on the impact of each of the alternatives on the institutions' and collateral market's behaviour?

5. Leaseurope's understanding of the three options reviewed by CEBS in considering how to take mitigation into account in a new large exposure regime is summarised in the table below:

#### Credit Risk Mitigation in a New Large Exposure Regime

Proposal 1	Proposal 2	Proposal 3
Eligibility	Eligibility	Eligibility
Minimum Requirements	Minimum Requirements	Minimum Requirements
Effect	Effect (if eligible)	Effect

**Key:**

Same as min cap req

Change

In proposal 1, eligibility criteria, minimum requirements and the effects of protection would be the same as in the current minimum capital requirements framework. Under proposal 2, the types of eligible protection would differ to the capital requirement framework; only those instruments considered liquid enough would be taken into account. In the last proposal, CEBS considers putting into place additional requirements to ensure the quality of the protection in a large exposure context and to accompany this with a more conservative calculation of the protection's effects.

6. We believe that these 3 proposals are relevant. However, we disagree with certain aspects of the cost benefit analysis conducted in the CP. For instance, CEBS argues that, if proposal 1 were to be adopted under a new large exposure regime, its effects would be less conservative than the current regime, thus resulting in an increased probability of an institution suffering "traumatic losses as a consequence of an unforeseen event risk". Although a new regime under proposal 1 would indeed lead to increased recognition of protection effects, this does not necessarily imply that it would pave the way for a higher probability of a systemic crisis. Instead, by putting in place a regime that encourages institutions to actively ensure that their protection is of high quality and when it is, allowing them to recognise this appropriately, is undoubtedly more conducive to achieving sound management of single name concentration risk than foregoing such an approach. Therefore, Leaseurope argues that taking into account the effect of protection, along with the appropriate monitoring and management of the protection (i.e. via the application of current minimum requirements in the capital rules framework), would lead to a better regime overall. Failure to put in place such an approach would imply that institutions who partake in active and sound management of their various protection instruments would be treated in the same manner as those who do not, with no incentive for the latter category to put better management in place.
7. Furthermore, we would like to add that we see additional costs to proposal 3 in that the possible "stricter interpretation" criteria mentioned by CEBS are for the most part already inherent in the minimum requirements under the minimum capital requirements framework (see paragraph 15 below).

## Physical Collateral in a Large Exposure Regime

Q13. Do you agree that physical collateral should not in general be eligible for large exposures purposes? Do you support CEBS' views that residential and commercial real estate should be eligible and that the current large exposures rules should be applied instead of the minimum capital rules? Please explain your views and provide examples. And where relevant, please provide feedback on the costs and benefits.

### *Recognising physical collateral other than real estate (eligibility)*

8. As pointed out to CEBS during the 15 January public hearing on large exposures, Leaseurope strongly disagrees with CEBS's view that physical collateral other than real estate should in general not be eligible for large exposure purposes. From our understanding of the comments made during the hearing, CEBS is ready to re-examine this position if industry can provide examples of sufficiently liquid physical collateral other than real estate. The following paragraphs therefore provide more detail on the level of liquidity of the types of assets that can typically be leased, other arguments in favour of their recognition under a large exposure regime as well as additional comments on this section of the CP.
9. Firstly, we would like to point out that for the leasing industry (in cases of both real estate and other physical assets leasing), CEBS's conclusion in §147 of the CP does not hold. For leasing firms subject to large exposure requirements on an individual basis and even within an application on a consolidated level, large leasing exposures do exist. Consequently, we see no justification for dismissing physical collateral recognition from a large exposure regime on grounds that such exposures do not arise, at least for leasing exposures, provided that is proved that these collateral are sufficiently liquid.
10. In the CP, CEBS raises concerns regarding the liquidity of physical collateral, examining the necessity for collateral to be realised in a timely manner and for the recoverable amount to be relatively certain. While we fully accept the necessity of these criteria, we do not agree that "other physical collateral" cannot meet them.
11. Aside from real estate leases, large exposures within the leasing industry will typically consist of so-called big ticket leasing transactions, which include but are not limited to the leasing of wide-bodied aircraft, ships, cranes and other yellow goods, rolling stock as well as other large assets such as integrated machine installations or infrastructure leases. In addition to these assets, while a car, truck, bus, trailer or container lease (amongst others) will not result in a large exposure on its own, these types of assets, particularly automotive assets, are often leased in fleets of hundreds of individual items to a single client and may thus result in large exposures.

12. It is important to note that the vast majority of these asset types are part of liquid secondary markets even in times of economic downturn, are easy to bring to the secondary market at a low cost, can be remarketed on different markets by many players and in different countries and are not subject to rapid technological development in comparison with the duration of the lease portfolio. Moreover, if the collateral has to be realised, due to the fact the lessor is the owner of the asset and does not have to exercise its security or mortgage right or go through lengthy bankruptcy procedures (as is the case with other secured loans), the lessor is in a position to repossess and realise the asset in a truly timely manner. Ownership is thus a key distinguishing feature of lease financing in this respect.
13. The above characteristics of leasing contracts have been confirmed by academic research, including:
  - LAURENT, M-P and SCHMIT, M. (2005), “Estimating “Distressed” LGD on Defaulted Exposures: A Portfolio Model Applied to Leasing Contracts”, in *Recovery Risk: The Next Challenge in Credit Risk Management*, First Edition, Risk Books, pages 307-322
  - DE LAURENTIS G. and GERIANO M. (2001) “Leasing recovery rates”, Bocconi University Business School Research, 21 pages.
14. The assets which fulfil these characteristics can thus be categorised as “standardised” assets. Consequently, when they are the objects of a leasing transaction, they should meet with CEBS’s criteria regarding liquidity and should be eligible for a large exposure regime.
15. Moreover, it should be pointed out that these criteria are already inherent in the minimum requirements for other physical collateral recognition – we refer CEBS to Annex VIII, Part II §10 points c, f, g, h, i, (part of the minimum requirements for other physical collateral recognition) and § 11 b, c, d (additional requirements for leasing) of the CRD. These provisions have been included within the CRD to ensure high quality monitoring of the collateral, its value, volatility, condition and timely realisation, amongst others. It should also be stressed that lease exposures have an additional set of requirements (i.e. §11) that further reinforce the collateral quality.<sup>1</sup>

*Recognising the effects of physical collateral in a new regime*

16. Similarly with real estate collateral and as described in § 148 of the CP, it would not be possible to recognise the effect of protection for other physical collateral in the same way as it recognised under capital requirements as this is done through adjustments of the LGD.
17. Leaseurope would thus propose that a simple alternative be introduced allowing institutions to recognise the protection of their leased assets by reducing the exposure amount up to a certain share of the value of the collateral, taking into account factors relating to the estimated time to realise the collateral and a proxy for the volatility of the asset price. This treatment should be available to all institutions regardless of the approach they apply and should not be subject to any level of national discretion. Institutions applying the treatment will have to respect the conditions relating to their assets as given in Annex VIII of the CRD.

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<sup>1</sup> We would like to recall Leaseurope’s longstanding view that these additional requirements are unduly burdensome for the leasing industry due to the fact that the lessor retains the ownership of the leased asset. This implies that a lessor has a stronger position than a secured lender who only disposes of an asset as a simple collateral against its exposure. As a result, Leaseurope believes that the additional conditions for leasing are unnecessary and unjustified.

18. Leaseurope is currently further developing such a framework and would appreciate the opportunity to work on it in conjunction with CEBS.

*Recognising real estate collateral (eligibility)*

19. Leaseurope strongly supports CEBS's initial proposal to recognise and to take real estate collateral into account, in a simple manner, in the new large exposure regime. We agree with their analysis that following minimum capital requirement treatment is not possible in this context and welcome the proposal that simple treatment be applied in all cases.

20. Regarding CEBS's initial suggestion for the recognition of the effects of such collateral in the large exposure framework, we would like to highlight the fact that, according to CEBS's stock take of the existing regime, a certain number of member states allow for **partial or full** exemption of real estate exposures under today's large exposure rules in virtue of Article 113.3 q of the CRD.

Indeed, this article states that:

*"3. Member States may fully or partially exempt the following exposures from the application of Article 111:*

*(...)*

*(q) the following, where they would receive a 50 % risk weight under Articles 78 to 83, and only up to 50 % of the value of the property concerned:*

- (i) exposures secured by mortgages on offices or other commercial premises, or by shares in Finnish housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation, in respect of offices or other commercial premises; and*
- (ii) exposures related to property leasing transactions concerning offices or other commercial premises;*

*for the purposes of point (ii), until 31 December 2011, the competent authorities of each Member State may allow credit institutions to recognise 100 % of the value of the property concerned. At the end of this period, this treatment shall be reviewed. Member States shall inform the Commission of the use they make of this preferential treatment;"*

21. We are of the opinion that CEBS's proposal to allow recognition of 50% of the value of the property in the large exposure for residential real estate and 50% of the value of the property under certain conditions for commercial real estate and property leasing transactions has reached middle ground in terms of the costs and benefits relative to the various proposal options discussed in the CP (and referred to in paragraphs 5 to 7 of this response). Furthermore, we agree with this proposal as it is in line with the application of the "50% rule" applied by some Member States under the current regime and welcome the fact that it is extended to all Member States.

*Recognising the effects of real estate collateral in a new regime*

22. As property leasing relates mainly to commercial real estate rather than residential real estate, we will limit the remainder of our comments in this section to the treatment of commercial property leasing.
23. CEBS's current proposal would allow for a mitigation effect in such cases to be recognised, if the exposure receives a "50% risk weight under Articles 73 to 83", i.e. for minimum capital requirement purposes. Indeed, this is the reflection of today's large exposure treatment given in Article 113.3 q and quoted above.
24. Leaseurope would like to point out a few potential issues that should be clarified when drafting the new regime. If our understanding is correct, the mention of "Articles 78 to 83", which set out the Standardised Approach for calculating capital requirements, refers to Annex VI, Part 1 §44 and § 51-60 for determining the risk weights for commercial real estate. Under this section, a 50% risk weight is applicable only as a matter of national discretion when authorities are satisfied that a certain set of conditions are met.
25. Our concerns are therefore as follows:
  - Although CEBS states that it wishes to remove all levels of national discretion in this area, if current treatment is maintained, it will be applicable only to a category of exposure that is subject to a national discretion. This is contrary to CEBS's stated objective as it is in effect potentially embedding a national discretion in the large exposure treatment.
  - To avoid confusion amongst readers, it should be made clear that even when a 50% risk weight applies to only 50% of the exposure under certain minimum capital rules, under a large exposure regime, the recognition of up to 50% of the value of the collateral would apply to 100% of the exposure. This treatment is justified due to the implications of the lessor's ownership of the property as set out in paragraph 12 of this response.
  - As article 113.3 q of the CRD refers only to the Standardised Approach, this implies that IRB institutions are not eligible for the recognition of real estate collateral, although very strict conditions for CRM purposes exist under these approaches. By the very nature of the advanced approaches, the risk weights for these types of exposures may not be a fixed 50% but will be based on internal calculations. It should therefore be clarified that the 50% recognition treatment would be applicable to all institutions, regardless of the approach they apply.
26. In conclusion, we strongly believe that it is necessary to make a clear distinction between minimum capital and large exposure rules in this case to avoid confusion and to clearly apply the large exposure treatment to all categories of institutions without any discretionary measures.

## II. Intra-group Exposures and Scope of Application

Q19. Do you have any comments on the market failure analysis on intra-group exposures?  
Q20. Could intra-group large exposures limits give rise to other costs and benefits? Please explain your response.  
Q21. What are your views on the proposals/options for the scope of application of the large exposures regime?  
Q22. Which treatment do you believe is the most appropriate for intra-group exposures i) to entities within the same Member State; ii) to group entities in different Member States and iii) to group entities in non-EEA jurisdictions ? Please explain your response.  
Q23. What are your views on the high level principles to define *intra-group limits*?

### Intra-group Exposures

- 27 While Leaseurope understands CEBS's concerns relating to exempting cross-border intra-group large exposures for the new regime, we would like to point out that in our view it is contrary to the objectives of a Single Market to discriminate between exposures made between group entities on the national level and those made between group entities in other EU member states.
- 28 We believe that this issue will be fully covered in the responses of other European federations but would like to point out that we are aware of cases within our membership where group level entities have concluded memorandum of understanding type agreements vis-à-vis their subsidiaries in other member states to meet their needs in cases of distress and that such agreements have been accepted by supervisors with the result that large exposures between these entities where the commitment holds are exempt from large exposure rules.
- 29 Additionally, we wish to draw CEBS's attention to the fact that Art 69 of the CRD is not an efficient tool in exempting national intra-group exposures as some local authorities have applied further restrictions to the conditions it contains, thereby creating an unlevel playing field for institutions who cannot benefit from intra-group exposure treatment even on the national level.
- 30 Lastly, from the leasing industry's point of view, we have a severe concern that funding availability will be severely affected for leasing entities of large international banking groups if cross-border intra-group exposures were to be subject to the large exposure regime. This is a non negligible cost for the industry that CEBS should fully take into account in its cost/benefit analysis.

## General Scope of Application for Leasing Institutions

Q25. Do you agree with the proposal on the treatment of other financial institutions for large exposures purposes? Please explain your response.

- 31 The scope of application of the CRD is complex for the European leasing industry. The CRD applies on an individual basis to leasing institutions which qualify as credit institutions in their own right or are subject to specific local requirements that call for the application of the CRD to leasing firms. On a consolidated level, all leasing companies belonging to groups who are themselves subject to the CRD will see their exposures taken into account on the consolidated level for purposes of applying the CRD.
- 32 This situation leads to a clear unlevel playing field for the European leasing industry, with some institutions being subject on a solo basis, others on a consolidated basis and yet others not having to apply the CRD at all.
- 33 While we agree that any financial institution that does not apply the CRD, and *a fortiori*, any leasing firm that is such an institution, should not have to apply the new large exposure regime, our concerns relating to the unlevel playing field due to these differences in the scope of application as explained above remain valid.

## III. Interbank Exposures

Q31. Given the market failure and costs/benefit analysis set out, what treatment would you consider appropriate for interbank exposures?  
Q32. Would a 25% limit on all interbank exposures unduly affect institutions' ability to manage their liquidity? Should maturity of the exposure continue to play a role? CEBS would find any practical examples useful as aids to its thinking (CEBS would not disclose confidential information).

- 34 Generally speaking, European leasing firms who are banks in their own right along with other kinds of specialised credit institutions providing lease finance, various other forms of asset finance or consumer credit, which typically tend to be smaller institutions, would face unwarranted constraints on their liquidity management.